

Tilford v. Commissioner: A Case for the Invalidity of Treasury Regulation § 1.83-6(d)

I. BACKGROUND

In *Tilford v. Commissioner*¹ a majority shareholder attempted to induce key employees to continue their employment with the corporation by transferring shares of stock of the corporation to the employees.² Relying on Treasury Regulation section 1.83-6(d), the Sixth Circuit held that Internal Revenue Code section 83(h) precludes the shareholder from recognizing a loss on the transfers of shares to the employees. The court viewed the transfers as contributions by the majority shareholder to the capital of the corporation, with a subsequent transfer of the shares by the corporation to the employees. The amount that the employees paid for the shares was considered to have been received by the corporation, which then made a distribution to the majority shareholder. Thus, instead of recognizing either a long-term capital gain or loss on the sale of stock for the difference between the shareholder's basis in the stock and the amount paid by the employees, the shareholder was faced with the possibility of dividend treatment equal to the amount paid by the employees for the stock.³

The purpose of this Comment is to point out the analytical deficiencies in the Sixth Circuit's holding, and to discuss the analysis that the court should have used in determining whether Treasury Regulation section 1.83-6(d) is a valid construction of Internal Revenue Code section 83(h). This Comment will show that the Treasury Regulation should not be considered valid because it is inconsistent with the statute and is contrary to well-established case law.

1. 705 F.2d 828 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

2. Several situations in which a shareholder, rather than the corporation, may want to transfer shares to an employee of the corporation are:

1. Where the corporation itself cannot afford to pay adequate compensation or is prevented from doing so (for instance, by restrictions in a loan agreement).
2. Where compensation in the form of stock is desired, but issuance of additional shares by the corporation would upset important stock holding relationships (such as 80% ownership by a corporate shareholder, equal stock holdings by two or more family groups, etc.).
3. Where the shareholder has some special financial interest in the success of the corporation (apart from his interest as a shareholder), as when he himself may become entitled to additional compensation or other payments under an incentive or contingent stock arrangement, and . . . wishes to provide corresponding incentive to a key employee.
4. Where a shareholder wants personal recognition of providing the additional compensation.
5. Where there is a difference of opinion among controlling shareholders whether additional compensation should be provided, and one or more shareholders determine to provide the same at their own expense.
6. Where preemptive rights prevent or limit the ability of controlling shareholders to cause the corporation to compensate key employees with stock.
7. Where a controlling shareholder wishes to sell out to other shareholders who are also employees.

Wray, *Transfers of Property by Shareholders to Corporate Employees under Section 83*, 52 J. TAX'N 152, 154 (1980). Reasons 1-5 were suggested by Stone, *Compensation Payments by Shareholders of Employer*, 30 INST. ON FED. TAX'N 349, 350 (1972).

3. *Tilford v. Commissioner*, 705 F.2d 828, 829-31 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

A. *The Tilford Facts*

Henry Tilford incorporated Watco, Inc., a magnetic sign manufacturing company, and was the company's principal officer and sole shareholder until 1970. Before the stock transfers that were the basis for the case, Tilford had invested \$350,000 in 170,000 Watco shares and had loaned an additional \$79,500 to the corporation.⁴ In 1970, attempting to stimulate Watco's financial operating performance, Tilford sought to motivate key employees by selling approximately 133,000 shares to them. The stock was sold at one dollar per share, but was subject to Tilford's right of first refusal to repurchase the stock at book value within five years if an employee decided either to sell the stock or to terminate employment with the company.⁵ The company continued to lose money, and Tilford repurchased all the shares he had sold to the employees.⁶

In his personal tax returns Tilford claimed capital losses on his sales of the Watco stock to the employees, taking deductions of \$370,992, \$150,497, and \$159,246 for 1971, 1972, and 1973, respectively.⁷ These deductions were disallowed by the Internal Revenue Service.⁸ Tilford contended that his losses were deductible pursuant to Internal Revenue Code section 165 and should be recognized in accordance with Code section 1002(b).⁹ However, the IRS claimed that the sales of Watco stock were transfers of property in connection with the performance of services to the corporation by the key employees, and thus should be governed by Code section 83.¹⁰ Specifically, the IRS relied on Treasury Regulation section 1.83-6(d) to characterize the transfers as contributions by Tilford to the capital of the corporation. Under this approach a shareholder's loss on the transfer is not recognized.¹¹

B. *IRC Section 83*

Section 83, added to the Code by the Tax Reform Act of 1969,¹² deals with the tax consequences of transfers of property to employees in connection with the performance of services.¹³ Generally, section 83(a) provides that when property is transferred "in connection with the performance of services" to any person other than the person for whom the services are performed, the service provider shall

4. *Tilford v. Commissioner*, 75 T.C. 134, 135 (1980), *rev'd*, 705 F.2d 828 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

5. *Id.* at 136-37.

6. *Id.* at 138-39.

7. 705 F.2d 828, 829 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

8. 75 T.C. 134, 139 (1980), *rev'd*, 705 F.2d 828 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

9. *Id.* at 145. The provisions of then-existing § 1002 are now contained in I.R.C. § 1001(c) (1982).

10. 75 T.C. 134, 139-40 (1980), *rev'd*, 705 F.2d 828 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

11. *Id.* at 143-44.

12. Tax Reform Act of 1969, Pub. L. No. 91-172, § 83, 83 Stat. 487, 588 (1969) (codified as amended at I.R.C. § 83 (1982)).

13. This section was enacted primarily to deal with "deferred compensation arrangements known as restricted stock plans." S. REP. NO. 552, 91st Cong., 1st Sess. 123, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 2027. "A restricted stock plan, generally, is an arrangement under which an employer transfers stock to one or more of his employees (often without the payment of any consideration), where the stock is subject to certain restrictions which affect its value." *Id.* at 2150-51.

include in gross income the excess of the fair market value of such property over the amount, if any, paid for the property.¹⁴ However, if the property transferred is subject to a substantial risk of forfeiture¹⁵ or is not transferable,¹⁶ the service provider does not recognize income until the restrictions terminate.¹⁷

Since each transfer of shares to a key employee in *Tilford* was in connection with services performed by the employee for the corporation, each employee recognized income to the extent the fair market value of the shares purchased exceeded their purchase price.¹⁸ However, each employee would recognize this income only if the shares were transferable and were not subject to a substantial risk of forfeiture.¹⁹

In addition to providing rules for the inclusion of income by the employee, subsection 83(h) allows²⁰ the employer an expense deduction under section 162.²¹ The deduction allowable is equal to the amount of income included²² by the employee and is deductible by the employer when this amount is included²³ in the income of the employee.²⁴

C. Treasury Regulation Section 1.83-6(d)

The Code does not specifically address the question posed in *Tilford*: What are the tax consequences to the shareholder, employee, and employer when the shareholder transfers property to the employee in connection with services provided by the

14. I.R.C. § 83(a) (1982).

15. *Id.* § 83(c)(1). "The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by an individual." *Id.*

16. *Id.* § 83(c)(2). "The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture." *Id.*

17. *Id.* § 83(a). However, the employee could elect under § 83(b) to include in the year of receipt the excess of the fair market value of the property over the amount paid, regardless of any restrictions on the property transferred.

18. *Id.*

19. However, if a substantial risk of forfeiture is deemed to exist, "the transferor shall be regarded as the owner of such property, and any income from such property received by the employee . . . constitutes additional compensation . . . [to the employee]. This paragraph applies to a transfer . . . even though the transferor is not the person for whom such services are performed." Treas. Reg. § 1.83-1(a)(ii) (1978). Consequently, any dividends received by the employee on the restricted stock will first be considered as constructively received by the transferor/shareholder who will have dividend income. The dividend will then be considered a contribution to capital of the corporation which, in turn, is considered to make a compensation payment to the employee. The employee will have income under § 83(a) and the employer will receive a deduction under § 83(h). See Bernstein, *Final Sec. 83 Regs: Dividends on Restricted Stock as Compensation*, 10 TAX ADVISER 132, 136-37 (1979). Treas. Reg. § 1.83-6(a)(2) therefore requires the corporation to withhold on the amount includible in the employee's income as a precondition to the deduction allowable under § 83(h). Thus, if the shareholder, not the corporation, makes the transfer, the corporation may not become aware of the transfer until it is too late to withhold from the employee. Wray, *supra* note 2, at 156.

20. Section 83(h) states: "[T]here shall be allowed as a deduction under § 162. . . ." I.R.C. § 83(h) (1982) (emphasis added). The words "shall be allowed," however, should not be read in isolation, because the deduction must meet the "ordinary and necessary" requirements of § 162(a) and the "reasonable compensation" limitation of § 162(a)(1). See Treas. Reg. § 1.83-6(a)(1) (1978).

21. I.R.C. § 83(h) (1982).

22. Section 83(h) should not be interpreted literally in this context either, because it allows a deduction when "such amount is included in the gross income of the [employee]." I.R.C. § 83(h) (1982) (emphasis added). The only workable rule is that the employer should have a deduction when that amount is includible by the employee. See Treas. Reg. § 1.83-6(a)(1) (1978); see also Solee, *Final Section 83 Regs. Endanger Employer Deductions, Premium on Employee Election*, 49 J. TAX'N 342, 343 (1978).

23. See *supra* note 22.

24. I.R.C. § 83(h) (1982).

employee to the employer? However, Treasury Regulation section 1.83-6(d), which was relied upon by the IRS in *Tilford*, purports to deal with the question as follows:

If a shareholder of a corporation transfers property to an employee of such corporation . . . in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee . . . under paragraphs (a) and (b) of this section. For purposes of this (1), [sic] such a transfer will be considered to be in consideration for services performed for the corporation if either the property transferred is substantially nonvested at the time of transfer or an amount is includible in the gross income of the employee . . . at the time of transfer under § 1.83-1(a)(1) or § 1.83-2(a). In the case of such a transfer, any money or other property paid to the shareholder for such stock shall be considered to be paid to the corporation and transferred immediately thereafter by the corporation to the shareholder as a distribution to which section 302 applies.²⁵

The regulation's legislative history is found in the Report of the Senate Finance Committee on the Tax Reform Act of 1969:

In general, where a . . . shareholder's stock is used to compensate employees under a restricted stock plan, the transfer of the stock by the . . . shareholder is to be treated as a capital contribution to the company which is to be entitled to a deduction in accordance with the restricted property rules. The . . . shareholder merely is to reflect the contribution as an increase of the equity in the company which is entitled to the compensation deduction.²⁶

Relying on Treasury Regulation section 1.83-6(d), the Commissioner contended that the majority shareholder in *Tilford* should recognize no gain or loss on his transfers of shares to the employees. Instead, each transfer should be considered a contribution to capital by the shareholder, with the corporation subsequently transferring the shares to each employee. Under this theory, each employee's payment for the stock is considered as having been paid to the corporation, which then made a distribution of these amounts to the shareholder. Accordingly, under Treasury Regulation section 1.83-6(d) the distribution to the shareholder is treated as a dividend, unless the distribution meets one of the exceptions contained in Code section 302.²⁷

II. ANALYSIS TO DETERMINE VALIDITY OF TREASURY REGULATIONS

Treasury Regulations ordinarily are considered valid constructions of the Internal Revenue Code if they "implement the congressional mandate in some reasonable manner."²⁸ This deference to the Treasury's construction of the statute is appropriate because Congress has expressly granted to the Secretary of the Treasury and his delegate, the Commissioner of the Internal Revenue Service, the authority to "prescribe all needful rules and regulations for the enforcement of" the Internal Revenue

25. Treas. Reg. § 1.83-6(d) (1978).

26. S. REP. NO. 552, 91st Cong., 1st Sess. 123, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 2027, 2155.

27. See *infra* text accompanying notes 39-53 for a detailed application of the provisions of § 83 to the facts of *Tilford*.

28. *United States v. Correll*, 389 U.S. 299, 307 (1967).

Code.²⁹ “But this general principle of deference, while fundamental, only sets ‘the framework for judicial analysis, it does not displace it.’”³⁰ In addition, less deference is owed to a regulation promulgated by the Commissioner under the general authority to prescribe “all needful rules and regulations”³¹ than a regulation issued under a specific grant of authority to define a statutory term.³² Consequently, an unreasonable interpretation of a Code section by the Commissioner should not be sustained by a court.³³

To determine if a regulation interprets the Code reasonably, the congressional intent behind the particular section in issue must be ascertained. Various considerations enter into a court’s determination of whether a regulation is consistent with its corresponding congressional intent. These considerations include a determination of the regulation’s consistency with the statute and an analysis of the case law existing at the time the statute originated.³⁴

A. Consistency With Statute

The issue in *Tilford* was whether Treasury Regulation section 1.83-6(d) should be invalidated as an unreasonable regulation not supported by the Code.³⁵ The starting point for the inquiry was established by the United States Supreme Court in *Commissioner v. South Texas Lumber Co.*,³⁶ wherein the Court held that “Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes.”³⁷ More recently, the Court has addressed and refined the general principle of *South Texas Lumber Co.* by stating, “In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose.”³⁸

1. Conflict With Code Section 1001(c)

Treasury Regulation section 1.83-6(d) requires that a shareholder’s transfer of shares to an employee in connection with services the employee performed for the corporation be treated as a contribution by the shareholder to the capital of the corporation.³⁹ The corporation then is viewed as distributing the shares to the employee.⁴⁰ Under this approach, the shareholder recognizes no gain or loss because the transfer to the corporation is deemed to be made at the shareholder’s basis in the

29. I.R.C. § 7805 (1982).

30. *United States v. Cartwright*, 411 U.S. 546, 550 (1973), cited in *United States v. Vogel*, 455 U.S. 16, 24 (1982).

31. I.R.C. § 7805 (1982).

32. *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981).

33. *United States v. Cartwright*, 411 U.S. 546, 557 (1973).

34. *National Muffler Dealers Ass’n v. United States*, 440 U.S. 472, 477 (1979).

35. 705 F.2d 828, 828-29 (6th Cir.), cert. denied, 104 S. Ct. 485 (1983).

36. 333 U.S. 496 (1948).

37. *Id.* at 501.

38. *National Muffler Dealers Ass’n v. United States*, 440 U.S. 472, 477 (1979).

39. See *supra* text accompanying notes 25-26.

40. *Id.*

shares.⁴¹ The basis in the shareholder's remaining shares then is increased by the amount of the basis in the shares transferred. The corporation recognizes no gain or loss on the distribution of the shares to the employee because Code section 1032 applies to the distribution. Section 1032 provides that "[n]o gain or loss shall be recognized to a corporation on the receipt of money or other property⁴² in exchange for stock⁴³ (including treasury stock) of such corporation."⁴⁴

Code section 302 governs the distribution to the shareholder of the amount deemed to be constructively received by the corporation from the employee in payment for the stock.⁴⁵ If the distribution from the corporation to the shareholder qualifies for treatment under one of the safe harbor provisions of section 302, the shareholder will be given exchange treatment⁴⁶ for the transfer of shares to the corporation.⁴⁷ If the mathematical safe harbor of section 302(b)(2)⁴⁸ does not apply, the shareholder must meet the more difficult provisions of section 302(b)(1)⁴⁹ in order to avoid dividend treatment under section 301.⁵⁰

Absent Treasury Regulation section 1.83-6(d), Code section 1001(c) would apply to a shareholder's transfer of stock to an employee. Section 1001(c) requires that "the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized."⁵¹ Thus, a shareholder's transfer of shares to an employee would trigger the general recognition provision of section 1001(c) for any realized gain or loss⁵² on the transfer. The shareholder's recognition of a gain or loss on the transfer, however, does not necessarily preclude the application of section 83. Section 83 creates additional tax consequences to the shareholder,

41. See Wray, *supra* note 2, at 153-54, for a comprehensive analysis of Treas. Reg. § 1.83-6(d).

42. "A transfer by a corporation of shares of its own stock . . . as compensation for services is considered, for purposes of section 1032(a), as a disposition by the corporation of such shares for money or other property." Treas. Reg. § 1.1032-1(a) (1960).

43. However, if the shareholder transfers appreciated property other than stock of the corporation/employer to the employee, § 1032 does not apply and, presumably, the shareholder could force the corporation to recognize a gain against its will. Wray, *supra* note 2, at 154.

44. I.R.C. § 1032(a) (1982).

45. See Treas. Reg. § 1.83-6(d)(1) (1978).

46. A transfer is given exchange treatment by certain Code provisions so that the "sale or exchange" requirement for having the transfer qualify as a long-term capital gain will not otherwise have to be met. See I.R.C. § 1222(3) (1982).

47. I.R.C. § 302(a) (1982) states that a distribution to a shareholder will be given exchange treatment only if one of the exceptions of § 302(b) applies. The 302(b) exceptions are: (1) Redemptions not equivalent to dividends; (2) Substantially disproportionate redemption of stock; (3) Termination of shareholder's interest; (4) Redemption from noncorporate shareholder in partial liquidation. *Id.* § 302(b).

48. I.R.C. § 302(b)(2) (1982).

49. The "not essentially equivalent to a dividend" provision of § 302(b)(1) was construed in *United States v. Davis*, 397 U.S. 301 (1971), to mean a "meaningful reduction in a shareholder's proportionate interest in the corporation." *Id.* at 313. Since the shareholder making the transfer to the employee is likely to be the controlling shareholder of a closely held corporation, § 302(b)(1) may be difficult to meet. Wray, *supra* note 2, at 154-55.

50. I.R.C. § 302(d) (1982). It has been contended that the Service treated the distribution to the shareholder under § 302 because it viewed the transfer from the shareholder to the employee essentially as a technique to bail out earnings and profits at capital gains rates rather than as a dividend. "In other words, such a transfer is really a roundabout-way for the corporation to issue stock to an employee and to redeem an equal amount of stock from the shareholder." Wray, *supra* note 2, at 154. However, other legitimate business reasons explain why a shareholder, rather than the corporation, may want to transfer shares to an employee of the corporation. See *supra* note 2. To require a shareholder to meet the requirements of § 302 would unduly hinder these valid transfers. *Id.*

51. I.R.C. § 1001(c) (1982).

52. See *infra* note 128 for the determination of the amount of gain or loss realized. See also O'Brien, *Stock Transfers by Shareholders to Outsiders for Nontangible Consideration*, 39 TAXES 675 (1961), for an analysis of cases concerning whether a loss should be realized, and if so, what the amount and character of the loss should be.

employee, and employer, but its application “does not render the transaction any the less a sale under section [1001(c)], as far as [the shareholder] is concerned.”⁵³

In sum, section 83 does not contain a provision rendering section 1001(c) inapplicable when a shareholder transfers shares to an employee in connection with services performed by the employee for the corporation. However, Treasury Regulation section 1.83-6(d) does make section 1001(c) inapplicable. Therefore, the regulation is in direct conflict with the express and fundamental Code provision of section 1001(c).

2. More Than “Technical Consistency” Is Required

In *Tilford*, the majority stated that Treasury Regulation section 1.83-6(d) is supported by the language of section 83(h), and therefore is consistent with and is a reasonable interpretation of the statute.⁵⁴ However, the United States Supreme Court has “firmly rejected the suggestion that a regulation is to be sustained simply because it is not ‘technically inconsistent’ with the statutory language, when that regulation is fundamentally at odds with the manifest congressional design.”⁵⁵

The Sixth Circuit’s position is that since Congress described the recipient of the deduction available under Code section 83(h) as “the person for whom were performed the services,”⁵⁶ it had contemplated the possibility of payments to employees by someone other than the employer. Thus, if Congress had meant to address only transfers by an employer to an employee, it would not have used such convoluted language.⁵⁷ In other words, Congress used the convoluted language of section 83(h) because it did not intend for a shareholder who transfers shares to an employee in connection with services performed by the employee for the corporation to receive the deduction under section 83(h).

While initially the Sixth Circuit’s argument seems appealing, it cannot withstand the scrutiny needed to discern the “manifest congressional design.” Assuming *arguendo* that the regulation can be supported by the language of section 83(h), the Supreme Court has rejected the argument that a regulation at odds with the “manifest congressional design” must be upheld whenever the statute can be read in a way technically consistent with the regulation.⁵⁸ The origin and purpose of section 83 are discussed more fully below,⁵⁹ but as previously mentioned, the regulation is in direct conflict with section 1001(c).⁶⁰ Consequently, it is at odds with the fundamental recognition provision of the Code.

Moreover, Treasury Regulation section 1.83-6(d) is not even “technically consistent” with section 83(h). The section 83(h) deduction available to “the person for

53. *Tilford v. Commissioner*, 75 T.C. 134, 145 (1980), *rev’d*, 705 F.2d 828 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

54. 705 F.2d 828, 830 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

55. *United States v. Vogel*, 455 U.S. 16, 26 (1982).

56. I.R.C. § 83(h) (1982).

57. 705 F.2d 828, 830 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

58. See *supra* text accompanying note 55.

59. See *infra* text accompanying notes 70–75.

60. See *supra* text accompanying notes 39–53.

whom were performed the services”⁶¹ is a compensation deduction for services rendered by the employee. The characterization of this deduction as a payment for services is indicated by the requirement that a deduction allowable under section 83(h) must first satisfy section 162.⁶² Furthermore, the amount of the deduction corresponds to the amount included in the employee’s income for services rendered.⁶³ The section 83(h) compensation deduction must be distinguished from the shareholder’s loss on the transfer of shares to the employee, the loss Treasury Regulation section 1.83-6(d) purports to disallow. The shareholder’s loss is premised on a deduction allowable under section 165 for the unrecovered basis in the stock transferred, not on the premise that the shareholder should be allowed a compensation deduction.⁶⁴ Thus, section 83(h), which supposedly is technically consistent with the regulation, actually does not address the type of loss disallowed by the regulation.

The language of section 83(h) can be interpreted merely as allowing a deduction to the corporation in a situation when, prior to the enactment of section 83(h), a deduction had been disallowed. Prior to section 83(h), when services were performed for a corporation but were paid for by a shareholder, no deduction was allowed to the corporation. The expense was regarded as having been paid by a third party,⁶⁵ even though in an economic sense a business expense had been incurred by the corporation.

This explanation of section 83(h) can be better understood if the transfer from the shareholder to the employee is viewed as embodying two separate tax events.⁶⁶ First, a sale of stock from the shareholder to the employee occurs. The gain or loss recognized under section 1001(c) on the sale is the difference between the fair market value of the stock at the time of the transfer and the shareholder’s basis in the stock. Second, the corporation incurs a business expense, for the services rendered to it by the employee, equal to the difference between the fair market value of the stock and the amount paid by the employee for the stock. This business expense is deductible by the corporation under section 162 because of section 83(h), whereas prior to the enactment of section 83(h), the corporation was precluded from recognizing an expense of doing business.⁶⁷ The distinction between the deduction taken by the shareholder and the deduction available to the corporation is not a mere technicality, but rather is the difference between a loss under section 165 and an expense under section 162.⁶⁸ The section 165 loss reflects the decline in value of the stock during the

61. I.R.C. § 83(h) (1982).

62. See *supra* text accompanying notes 20–24.

63. I.R.C. § 83(h) (1982).

64. See *infra* text accompanying notes 122–30 for a discussion of the difference between a § 83(h) deduction and a deduction under § 165.

65. *Zoby v. United States*, 364 F.2d 216, 219 (4th Cir. 1966); see also Hindin, *Internal Revenue Code Section 83 Restricted Stock Plans*, 59 CORNELL L. REV. 298, 336 (1974), which views Treas. Reg. § 1.83-6(d) as allowing the corporation a previously disallowed deduction.

66. The Tax Court recognized that two separate tax events were presented in *Tilford* by stating: “We do not view the loss resulting from the disposition of shares by a stockholder as the same economic loss or expenditure as that associated with the payment for services rendered.” *Tilford v. Commissioner*, 75 T.C. 134, 146–47 (1980). For support of the two transaction theory, see Manwell, *Transfers of Partial Stock Interests to Corporate Employees: A Composite Alternative*, 1 J. CORP. TAX’N 275, 286–92 (1974); O’Brien, *supra* note 52.

67. See *Zoby v. United States*, 364 F.2d 216, 219 (4th Cir. 1966); *supra* text accompanying note 65.

68. See *infra* text accompanying notes 122–30.

taxpayer's holding period, while the expense deduction under section 162 reflects the value of services rendered to the corporation.

Consequently, Congress may have used the convoluted language of section 83(h) because it was aware that the transferor of property to an employee might be someone other than the employer. However, the language of section 83(h) refers only to the compensation deduction for the value of services rendered to the corporation. It does not attempt to deal with recognition of gain or loss on the transfer of stock. While section 83(h) should be interpreted to deny the shareholder a compensation deduction, it should not preclude the shareholder's recognition of loss under section 165.

3. *Inconsistent with Statute's Origin and Purpose*

Consistency with the language of the statute is not the only consideration relevant to the determination of a Treasury regulation's validity. Whether the regulation is consistent with the statute's origin and purpose also must be examined.⁶⁹

Section 83 originated because the Internal Revenue Code did not contain provisions specifically governing the tax treatment of deferred compensation arrangements known as restricted stock plans.⁷⁰ A restricted stock plan is an arrangement under which an employer transfers stock to one or more employees at no cost or at a bargain price, and the stock is subject to certain restrictions that affect its value, such as the condition that if the employee terminates employment within a specified period the employee must resell the stock to the employer.⁷¹ Congress was concerned with restricted stock plans because income recognition to the employee was deferred until the restrictions lapsed, at which time only the value of the stock *at the time of transfer* was treated as compensation.⁷²

The legislative history of section 83 therefore manifests Congress' desire to broaden the income-recognition provisions of the Code. Additionally, section 83's content⁷³ and location within the Code⁷⁴ indicate that it is an income-defining section enacted primarily to deal with the recognition of income under restricted stock plans. With the exception of section 83(h), section 83 has nothing to do with deductions. Furthermore, section 83(h) does not even address the tax consequences of a shareholder's transfer of stock to an employee in connection with services performed by the employee for the corporation. Thus, in addition to being inconsistent with

69. *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 477 (1979).

70. S. REP. NO. 552, 91st Cong., 1st Sess. 123, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 2027, 2150.

71. *Id.* at 2150-51.

72. The existing Treasury regulations generally provide that no tax is imposed when the employee receives the restricted stock. Tax is deferred until the time the restrictions lapse; at that time, only the value of the stock when it was transferred to the employee (determined without regard to restrictions) is treated as compensation. . . . Thus, under existing regulations there is a deferral of tax with respect to this type of compensation, and any increase in the value of the stock between the time it is granted and the time when the restrictions lapse is not treated as compensation.

Id. at 2151.

73. The primary emphasis of § 83 is one of defining income. See I.R.C. § 83(a)-(f) (1982).

74. Section 83 is located in Part II, "Items Specifically Included In Gross Income," of Subchapter B, "Computation of Taxable Income," of Subtitle A, "Income Taxes," of the Internal Revenue Code.

other Code sections, Treasury Regulation section 1.83-6(d) is clearly outside the scope of section 83.⁷⁵

4. Other Considerations

Section 83 was enacted in 1969.⁷⁶ However, the final Treasury Regulations under section 83 were not issued until 1978,⁷⁷ although they had been published in proposed form earlier.⁷⁸ The Supreme Court has declared that if a regulation is not a “substantially contemporaneous construction of the statute . . . the manner in which [the regulation] evolved merits inquiry.”⁷⁹ In *Hart v. United States*,⁸⁰ the Court of Claims had to choose between statutory terms and legislative history, which were in conflict. In making the choice, the court stated:

The [United States Supreme] Court has ordinarily expressed a wary attitude in dealing with legislative history invoked by one seeking to expand the literal scope of an Act. For example, in *Piper v. Chris-Craft Industries, Inc.*, . . . the Court noted that “[r]eliance on legislative history in divining the intent of Congress is, as has often been observed, a step to be taken cautiously.” This hesitation in resorting to legislative history to contradict plain statutory language is timely. We note that with the swiftly growing use of the staff system in Congress, many congressional documents may be generated that are not really considered fully by each or perhaps by any legislator. Thus, committee reports and the like are perhaps less trustworthy sources of congressional intent than they used to be, and less than the actual wording of the legislation, which one would hope received more thorough consideration prior to enactment.⁸¹

In addition to the Court’s reluctance to permit the use of committee reports to contradict plain statutory language, it is possible that the language⁸² in the Senate Finance Committee Report relied upon by the Commissioner was not even intended by the Committee to be a requirement of the reported legislation, but was merely a committee directive to the Commissioner.⁸³

“[E]veryone who has dealt with congressional committees knows that their reports, when made, are replete with Committee commands. They expect this, they require that, they disapprove of the other, and it must not be done. . . . As a practical matter they are usually effective because addressed to persons who cannot afford to incur Committee wrath.

. . . .

. . . The only trouble is the Committee failed to embody its wishes in an enacted bill. If this failure is not decisive of the case before us, the Committee is potent indeed.⁸⁴

75. See *supra* text accompanying notes 39–53.

76. Tax Reform Act of 1969, Pub. L. No. 91-172, § 83, 83 Stat. 487, 588 (1969).

77. T.D. 7554, 1978-2 C.B. 71.

78. Proposed I.R.C. Income Tax Regulations, 36 Fed. Reg. 10,787 (1971); see McFadden, *Final Regulations Under Section 83—Changes from 1971 Proposed Regulations*, 57 TAXES 123 (1979), for changes in the final regulations. For a comprehensive review of the final § 83 regulations see Solee, *Final Section 83 Regs Will Have Major Impact on Compensatory Property Payments*, 49 J. TAX’N 258 (1978); Solee, *Final Section 83 Regs. Endanger Employer Deductions, Premium on Employee Election*, 49 J. TAX’N 342 (1978).

79. *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981) (quoting *National Muffler Dealers Ass’n v. United States*, 440 U.S. 472, 477 (1979)).

80. 585 F.2d 1025 (Ct. Cl. 1978).

81. *Id.* at 1033.

82. See *supra* text accompanying note 26.

83. *Tilford v. Commissioner*, 705 F.2d 828, 832 (6th Cir.) (Nichols, J., dissenting), *cert. denied*, 104 S. Ct. 485 (1983).

84. *Id.*

Assuming, *arguendo*, that the language in the Senate Finance Committee Report was more than a directive to the Commissioner, it is not clear that the regulation drafted by the Commissioner is consistent with this language. The Report language can be interpreted to allow a loss to the shareholder on the transfer of shares to the employee, in addition to the tax consequences imposed on the employee under section 83(a) and the employer under section 83(h). For example, the Report states that the shareholder's transfer of the stock is to be treated as a capital contribution to the corporation "in accordance with the restricted property rules . . . [and] the shareholder merely is to reflect the contribution as an increase of the equity in the company entitled to the compensation deduction."⁸⁵ Accordingly, the capital contribution called for by the Report can be viewed as an amount equal to the compensation deduction available to the corporation under section 83(h) and not as a contribution to capital in the amount of the shareholder's basis of the stock transferred. Moreover, the Report can be interpreted to mean that before the corporation is entitled to a deduction under section 83(h), the shareholder should be deemed to have made a contribution to capital in the amount of the corporation's compensation deduction, not in the amount of the shareholder's basis in the stock transferred. Finally, the language in the Report does not necessarily preclude the recognition of a section 1001(c) loss on a transfer of shares by the shareholder, but only ensures that the shareholder will not receive a compensation deduction under section 162.⁸⁶

B. Conflict With Existing Case Law

Not only is the regulation⁸⁷ in conflict with express statutory provisions, but it is also in diametric opposition to case law existing prior to the enactment of section 83. Undoubtedly Congress could have decided to enact legislation that contradicted, and thus superseded, any prior case law, but chose not to do so by the terms of section 83. Yet the regulation⁸⁸ adopts the contribution to capital approach to analyze a transfer by a shareholder to an employee of the corporation,⁸⁹ whereas case law existing prior to the enactment of section 83 consistently rejected the contribution to capital theory.⁹⁰

In *Downer v. Commissioner*,⁹¹ a case with facts similar to those in *Tilford*, the Tax Court rejected the contribution to capital theory. In *Downer* the majority shareholders of a corporation transferred 100,000 shares of stock in the corporation to

85. S. REP. NO. 552, 91st Cong., 1st Sess. 123, reprinted in 1969 U.S. CODE CONG. & AD. NEWS 2027, 2155.

86. See *infra* text accompanying notes 108–21.

87. Treas. Reg. § 1.83–6(d) (1978).

88. *Id.*

89. See *supra* text accompanying note 25.

90. See, e.g., *Peabody Coal Co. v. United States*, 8 F. Supp. 845, 848–49 (Ct. Cl. 1934); *Downer v. Commissioner*, 48 T.C. 86, 89–93 (1967); *Sack v. Commissioner*, 33 T.C. 805, 807–08 (1960); *Estate of Foster v. Commissioner*, 9 T.C. 930, 934–38 (1947); *Miller v. Commissioner*, 45 B.T.A. 292, 297–99 (1941), *acq.* 1941–2 C.B. 9, *acq. withdrawn and nonacq. substituted*, 1977–1 C.B. 2; *Budd Int'l Corp. v. Commissioner*, 45 B.T.A. 737, 745–56 (1941), *acq.* 1942–2 C.B. 3, *acq. withdrawn and nonacq. submitted*, 1977–1 C.B. 2, *rev'd on other grounds*, 143 F.2d 784 (3d Cir. 1944), *cert. denied*, 323, U.S. 802 (1945); *Burdick v. Commissioner*, 20 B.T.A. 742, 746–48 (1930), *nonacq.* 1931–2 C.B. 82, *aff'd on other grounds*, 59 F.2d 395 (3d Cir. 1932); *Wright v. Commissioner*, 18 B.T.A. 471, 472–73 (1929), *modified*, 47 F.2d 871 (7th Cir. 1931); see also O'Brien, *supra* note 52, which analyzes these pre-§ 83 cases allowing the recognition of a loss in this context. But see *infra* notes 100–02 and accompanying text.

91. 48 T.C. 86 (1967).

an employee to induce him to continue his employment.⁹² The shareholders' basis in the stock transferred was \$100,000 and the fair market value of the shares was \$15,000 at the time of transfer.⁹³ The Tax Court found that the transfers to the employee were taxable events giving rise to a loss deduction for each shareholder, not contributions to the capital of the corporation.⁹⁴ The shareholders recognized, in sum, an \$85,000 capital loss.⁹⁵

The *Downer* court was presented with the argument that the contribution to capital theory should be adopted because under the unitary view of a shareholder's investment, the determination of gain or loss is deferred until the whole transaction is considered complete, that is, when all the shareholder's shares are sold.⁹⁶ The unitary view is based on the proposition that the shareholder transferred stock to the employee in order "to protect and make more valuable the stock which he continue[d] to own."⁹⁷ The Tax Court in *Downer* rejected the unitary view of a stockholder's investment in a corporation and therefore refused to accept the contribution to capital theory. In accepting the fragmented view the court reasoned:

There is no necessary lack of logic in the proposition that a shareholder realizes no gain or loss until he has disposed of his entire stock investment. Clearly, however, the evolution of the statutory and decisional framework has been on a fragmented, i.e., share by share, rather than a unitary view of a shareholder's investment. . . .

Once the fragmented view is accepted—as we think it must be—it is possible to draw a distinction between the situation where a shareholder transfers cash and where he transfers part of his shares to a third party. In the former case, there is no change in his proportionate shareholder interest in the corporation—only his investment has been varied. In the latter case, such a change admittedly takes place.⁹⁸

Treasury Regulation section 1.61-6(a) is also based on the "fragmented view." It states:

When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. *Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.*⁹⁹

The only authority utilizing the contribution to capital theory is *Schleppy v. Commissioner*.¹⁰⁰ However, the *Schleppy* court specifically chose not to overrule

92. *Id.* at 88-89.

93. *Id.*

94. *Id.* at 95.

95. *Id.*

96. *Id.* at 90-91.

97. *Id.* at 90 (quoting *Wright v. Commissioner*, 18 B.T.A. 471 (1929), *modified*, 47 F.2d 871 (7th Cir. 1931)); see also *supra* note 2 for a review of the reasons why a shareholder would make such a transfer to an employee.

98. 48 T.C. 86, 90-91 (1967).

99. Treas. Reg. § 1.61-6(a) (1960) (emphasis added); see also Bolding, *Non-Pro Rata Stock Surrenders: Capital Contribution, Capital Loss or Ordinary Loss?* 32 TAX LAW. 275, 278 (1978).

100. 601 F.2d 196 (5th Cir. 1979); see Bolding, *supra* note 99, which points out the consistent rejection of the contribution to capital theory.

Downer because in *Downer* the shareholder transferred a substantial portion of his stock investment, while in *Schleppy* the shareholder transferred only two percent of his stock. In light of this minimal reduction of ownership, the *Schleppy* court adopted the unitary view because the shareholder was in substantially the same investment position.¹⁰¹ However, even if *Schleppy* should be followed, and the “substantially the same investment position” theory were adopted, the *Tilford* facts do not call for its application because Tilford transferred 133,000 of his 170,000 shares in Watco.¹⁰² Consequently, the *Tilford* court erred in adopting the contribution to capital theory.

III. CRITIQUE OF *TILFORD*

The analysis used by the Sixth Circuit in *Tilford* to uphold the validity of Treasury Regulation section 1.83-6(d) is deficient in several respects. First, the court did not apply the analytical framework and the considerations necessary to determine if a regulation is unreasonable, but merely stated that the “regulation appears to us to be consistent with both the legislative history and statutory intent of section 83(h).”¹⁰³ Although deference is ordinarily owing to a Treasury Regulation, the Supreme Court has stated that “this general principle of deference, while fundamental, only sets ‘the framework for judicial analysis, it does not displace it.’”¹⁰⁴ Consequently, the court’s failure to evaluate the considerations established by the Supreme Court as relevant to the determination of a Treasury Regulation’s validity reveals the Sixth Circuit’s displacement of proper judicial analysis.¹⁰⁵

Second, the Sixth Circuit failed to recognize that two separate transactions were involved in the shareholder’s transfer of shares to the employees. The first transaction was the sale of shares from the shareholder to the employees; the second was a compensation payment to the employees by the corporation. The court’s failure to perceive these two events is evidenced by its statement that “[s]ince the statute allows a deduction for compensation, the statute makes clear that Congress rejected the view that the transaction was merely a sale by a shareholder to an employee.”¹⁰⁶ Indeed, the transaction is not merely a sale by a shareholder to an employee; it also has tax ramifications under section 83. In other words, the shareholder’s recognition of loss is not necessarily incompatible with the provisions of section 83.¹⁰⁷ Both compensation to the employee and recognition of loss by the shareholder are involved in the transaction.

Third, the Sixth Circuit illustrated its confusion of the issues by stating that the language in the Senate Finance Committee Report, which supports Regulation sec-

101. 601 F.2d 196, 198 (5th Cir. 1979).

102. See *supra* text accompanying notes 4–11. However, the approach used in *Schleppy* should not be adopted for the reasons enumerated *supra* text accompanying notes 81–86. Furthermore, it is questionable whether the *Schleppy* court correctly analyzed the criteria necessary for a loss deduction under I.R.C. § 165. See *infra* text accompanying note 120.

103. 705 F.2d 828, 830 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

104. *United States v. Vogel*, 455 U.S. 16, 24 (1982) (quoting *United States v. Cartwright*, 411 U.S. 546, 550 (1973)).

105. See *supra* notes 28–102 and accompanying text for the proper analysis in the determination of a Treasury regulation’s validity.

106. 705 F.2d 828, 831 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

107. See *supra* notes 51–53 and accompanying text.

tion 1.83-6(d), is consistent with the holdings of the United States Supreme Court in *Deputy v. DuPont*¹⁰⁸ and *Interstate Transit Lines v. Commissioner*.¹⁰⁹ The *DuPont* case involved a shareholder's payment to a third party for the benefit of the corporation.¹¹⁰ The *DuPont* Court relied upon two landmark cases to deny the shareholder's deduction under the predecessor of current section 162. First, the Court cited *Welch v. Helvering*¹¹¹ to determine that the "ordinary and necessary" requirement of section 162 had not been met.¹¹² Second, the Court declared that the claimed expenses were not directly related to the shareholder's trade or business as required under section 162 and *Burnet v. Clark*.¹¹³ In *Interstate* the Court followed *DuPont* and specifically determined whether the "carrying on a trade or business" requirement of section 162 was met.¹¹⁴

As applied to the *Tilford* facts, *DuPont* and *Interstate* hold that if a shareholder makes a cash payment to an employee for services rendered to the corporation, the shareholder is not entitled to a deduction under section 162 because the payment does not constitute an "ordinary and necessary"¹¹⁵ expense incurred in the shareholder's trade or business.¹¹⁶ However, the shareholder in *Tilford* was not claiming a compensation deduction under section 162, but rather was seeking to deduct a loss under section 165 for the decline in value of his stock.¹¹⁷ Under section 165 no "ordinary and necessary" requirement exists. Section 165 only requires that the loss be "incurred in any transaction entered into for profit"¹¹⁸ or "incurred in [the shareholder's] trade or business."¹¹⁹ The court's reliance on the *DuPont* and *Interstate* holdings demonstrates its failure to view the transfer as two separate transactions and its inability to recognize that a loss deduction under section 165 is not subject to an "ordinary and necessary" requirement.

The Sixth Circuit's confusion over the difference between a loss deduction under section 165 and an expense deduction under section 162 further is evidenced by its reliance on *Schleppy*,¹²⁰ wherein the court also misapplied *DuPont* and *Interstate*. The *Schleppy* court correctly held that the deduction in question fell under section 165, but went on to say that because of *DuPont* and *Interstate* the stockholder was not allowed a "loss deduction as 'ordinary and necessary expenses . . . in carrying on' the 'trade or business' of the taxpayer."¹²¹ Again, no "ordinary and necessary" requirement exists under section 165.

In summary, the Sixth Circuit, by reversing the Tax Court's well-reasoned

108. 308 U.S. 488 (1940).

109. 319 U.S. 590 (1943).

110. 308 U.S. 488, 490-92 (1940).

111. 290 U.S. 111 (1933).

112. *Deputy v. DuPont*, 308 U.S. 488, 494-95 (1940).

113. *Id.* at 493 (construing *Burnet v. Clark*, 287 U.S. 410, 418-19 (1932)).

114. *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 594 (1943).

115. *See* I.R.C. § 162(a), (d), (e) (1982).

116. *See* *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 594 (1943); *Deputy v. DuPont*, 308 U.S. 488, 494-95 (1940).

117. *See supra* text accompanying notes 4-11.

118. I.R.C. § 165(c)(2) (1982).

119. *Id.* § 165(c)(1).

120. 705 F.2d 828, 830-31 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983).

121. *Schleppy v. Commissioner*, 601 F.2d 196, 197 (5th Cir. 1979).

opinion, failed to consider the necessary factors in determining the reasonableness of a Treasury regulation and demonstrated an inability to analyze the Internal Revenue Code.

IV. RECOMMENDED RESOLUTION: TWO SEPARATE TRANSACTIONS

In determining how the *Tilford* court should have interpreted subsection 83(h), this Comment reconciles the provisions of section 83(h) with other Code provisions and well-established case law. The transfer of shares from a shareholder to an employee in connection with services performed by the employee for the corporation should be viewed as being comprised of two separate and distinct transactions, not as one integrated tax event.¹²² The Tax Court in *Downer* made this distinction, and clearly stated that the deduction afforded the shareholder was a loss on the transfer of his stock, not a deduction arising because the shareholder made a payment to the employee for the benefit of the corporation.¹²³

The first of the two transactions is a sale of the shareholder's stock to the employee. The realized gain or loss is recognized under section 1001(c). The gain or loss recognized reflects only the appreciated or depreciated value of the stock during the shareholder's holding period—nothing else. If the shareholder would have sold shares to the employee at a gain, the necessity of applying the recognition provisions of section 1001(c) becomes apparent. Under the *Tilford* rationale this gain would not be recognized at the time of the transfer, but rather would be deferred until the shareholder disposed of his or her remaining stock.¹²⁴

The second tax event is a compensation payment to the employee in the form of a transfer of stock to the employee at less than fair market value. This tax event is present only because of section 83, which imposes further tax consequences on the shareholder, employee, and corporation. Since the transfer to the employee in *Tilford* was made to induce employees to continue their employment with the corporation, it falls within the ambit of section 83 as a transfer of property "in connection with the performance of services."¹²⁵ Thus, under section 83(a) an employee has income to the extent the fair market value of the stock transferred exceeds the price paid by the employee. However, because of section 83(h) the corporation, as "the person for whom were performed the services,"¹²⁶ is entitled to a deduction under section 162 for the amount includible in the employee's income under section 83(a), or, in other words, for the fair market value of services rendered to the corporation.¹²⁷ However,

122. See *Tilford v. Commissioner*, 75 T.C. 134, 146–47 (1980), *rev'd*, 705 F.2d 828 (6th Cir.), *cert. denied*, 104 S. Ct. 485 (1983); see also *supra* note 66.

123. If a cash payment had been involved herein, there is no question that petitioner would have been held to have made a capital contribution to the corporation and he would not have been entitled to any loss. . . .

. . . .
... We hold that in the type of transaction involved herein, a deductible loss is . . . [appropriate].
Downer v. Commissioner, 48 T.C. 86, 90, 92 (1967); see *supra* notes 91–98 and accompanying text for the facts of *Downer*.

124. See *supra* text accompanying notes 39–53.

125. I.R.C. § 83(a) (1982).

126. *Id.* § 83(h).

127. See *supra* text accompanying notes 85–86.

section 83 does not alter the notion that a gain or loss should be recognized under section 1001(c). Also, the corporation's compensation expense deduction is not equivalent to the loss¹²⁸ deductible by the shareholder on the transfer. Thus, a claim of a double deduction is not warranted. Again, the loss deductible under section 165 reflects the depreciated value of the stock during the shareholder's holding period, while the compensation expense deduction by the corporation under section 162 represents an expense for services rendered.

This expense treatment, separate from the loss recognized by the shareholder, is consistent with the language used in section 83(h) and can be viewed as the allowance of a deduction by the corporation when none had previously existed.¹²⁹ In other words, prior to the enactment of section 83(h) a corporation was not allowed a deduction for services rendered to it if the corporation did not have any outlay for the expense, even though economically it was a cost of doing business.¹³⁰

V. CONCLUSION

The resolution of the issue in *Tilford*—what tax consequences result from a transfer of stock by a shareholder to an employee in connection with services performed by the employee for the corporation—should begin with a determination of the validity of Treasury Regulation section 1.83-6(d). This regulation is outside the scope of Code section 83 and is inconsistent with the express statutory provision of section 1001(c). The regulation is also inconsistent with case law explicitly rejecting the application of the contribution to capital theory when a shareholder transfers shares to an employee in connection with services the employee performed for the corporation. Thus, because of the generally accepted fragmented view of stock ownership, the shareholder should recognize a gain or loss under section 1001(c) on the disposition of a portion of his shares in the corporation. However, just because the gain or loss should be recognized on the sale from the shareholder to the employee does not preclude the application of section 83 to the transfer. Consequently, in addition to the tax consequences imposed because the gain or loss should be recognized on the transfer, the employee should also recognize income under section 83(a)

128. Even though the shareholder is entitled to a loss deduction under § 165 for the transfer to the employee, the shareholder will not be able to create losses by selling his stock holdings at substantially below the fair market value of the stock on the date of transfer. This is so because the "amount realized" under § 1001(a) does not necessarily equal the cash received from the employee. In *Helvering v. Horst*, 311 U.S. 112 (1940), the Supreme Court stated that "where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him." *Id.* at 115. Consequently, if the sales price paid by the employee is less than the fair market value at the time of transfer, the fair market value will be used as the amount realized under § 1001(a) because the total value (appreciated or depreciated) of the stock will be attributed to the shareholder under *Horst* and general principles of income attribution. Thus, the difference between the fair market value of the stock and the shareholder's basis will determine the realized loss under § 165, but the difference between the fair market value of the stock and the purchase price paid by the employee will determine the amount includible by the employee under § 83 and the amount the corporation deducts under § 162 by way of § 83(h). See O'Brien, *supra* note 52, which analyzes the split of authority, prior to the adoption of § 83, over the calculation of the amount of loss. The predominant view, set out above, was countered by a view that the amount of loss should be the full basis of the stock transferred (when the stock was transferred for no consideration) because the contemplated advantage to the employee was deemed too speculative.

129. See *supra* text accompanying note 65.

130. *Id.*

to the extent that the fair market value of the shares exceeds the purchase price. And, the employer should be entitled to a deduction under section 162 for the amount includible in the employee's income under section 83(a). The expense deduction allowable to the corporation reflects the economic cost to the corporation of the services rendered to it by the employee, while the loss deduction available to the shareholder, if a loss was actually realized, represents the depreciated value of the stock during the shareholder's holding period.

Because the *Tilford* decision does not view the shareholder's transfer to the employees in this manner, the Sixth Circuit has restricted a bona fide and useful method of motivating and compensating employees of closely-held corporations.¹³¹

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131. See *supra* note 2.

